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Europe's Deflationary Future

FEBRUARY 7, 2011

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OPENING STATEMENT

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Patience is a virtue. Greed is a curse. Greed is a human impulse, instinctive to most. Patience, while not an impulsive gesture, is instinctive to some. For others it is a learned behavior.

Regardless what type of person you are, if you want to become a successful investor, you must be patient and you must expel greed from your mind.

You must also stay away from noise. Most people have plenty of relevant distractions in their life. This is understandable. But you have no time for distractions when it comes to the investment process, as they are often dangerous, but never beneficial.

I speak of this because we are now entering a period that I view to be extremely difficult to forecast with reasonable certainty. Therefore, we must remain focused and alert, all while avoiding distractions and smoke screens. When confusion or uncertainty arises, we must remain patient and wait for more definitive signs of clarity.

Fortunately, my forecasts have been spot on for quite some time. But all that means is that the probability that I will be wrong in my next forecast has increased. This does not concern me because I am aware of this reality. I do not mind missing a few calls here and there, as this is to be expected. It is the number of calls over time that is important.

You too should rate your abilities and decisions using the same mindset. Over time, as you gain more insights and skills, your hit-miss ratio should improve.

Until you become an advanced investor, you should remain conservative, only engaging in investment strategies and opportunities that are less risky, and therefore more rewarding.

No doubt, as you become better in this process, you will express investment regret as you look back to missed opportunities. You will know you are becoming a better investor when your regret is centered upon missing previously spotted opportunities rather than mourning over your losses.

Investors do poorly for the same reason why most businesses fail—they run out of cash. Likewise, investors often loss money and miss out on tremendous opportunities because they run out of cash.

Staying liquid is especially important during this period. Although the market continues to reflect a good deal of optimism, you should maintain a healthy level of cash. This is especially true if you are less active. More active traders and investors will be better positioned to react more rapidly and can raise cash at the early signs of trouble.

Always remember my credo—stick with certainty and stay away from uncertainty because investment opportunities are endless, while cash is limited.

If you want to take on new investment opportunities, you will need to sell other positions, while focusing on building your cash position. Your focus should always be on investing rather than speculating. If you do not know the difference, at some point you will learn the hard way.

In this issue I will do as I have in the past. I will reiterate my forecast for the stock market, cover previously mentioned securities, add new ones, discuss macroeconomics, and hopefully provide valuable insight.

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GLOBAL ECONOMIC OVERVIEW

Over the next few pages, I have repost some charts from recent issues to remind you of the long-term challenges faced by many parts of the world.

My purpose is to help you keep this big picture in perspective as we continue to feed upon the positive but superficial momentum seen regarding the U.S. economy.

Likewise, while emerging markets have underperformed the U.S. market for over a year now, we are seeing the pessimism towards the emerging markets heighten, as inflation concerns grow. While these concerns are valid, this does not change the positive long-termer picture of emerging market growth.

Subscribers who have been with me since 2009 realize that I have been cautious about the emerging market EFTs since the later portion of 2009. Since that time, emerging market performance (China, India and Brazil) has significantly underperformed the U.S. market. I see no signs of this trend reversing in the near-term.

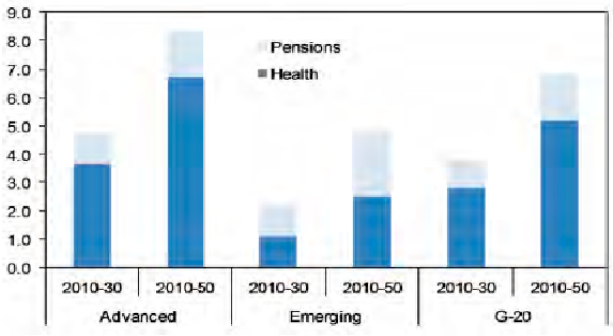
Average primary balance required to stabilise the public debt/GDP ratio at the 2007 level[1]

	Over 5 years	Over 10 years	Over 20 years	*Memo: Primary balance in 2011 (forecast)*
Austria	5.1	3.0	2.0	*–2.9*
France	7.3	4.3	2.8	*–5.1*
Germany	5.5	3.5	2.4	*–2.0*
Greece	5.4	2.8	1.5	*–5.3*
Ireland	11.8	5.4	2.2	*–9.2*
Italy	5.1	3.4	2.5	*0.0*
Japan	10.1	6.4	4.5	*–8.0*
Netherlands	6.7	3.7	2.3	*–3.4*
Portugal	5.7	3.1	1.8	*–4.4*
Spain	6.1	2.9	1.3	*–6.6*
United Kingdom	10.6	5.8	3.5	*–9.0*
United States	8.1	4.3	2.4	*–7.1*

[1] As a percentage of GDP.

Sources: OECD; authors' calculations.

Projected Increases in Pension and Health Spending



Source: IMF staff projections; see IMF 2010c.

Fiscal situation and prospects[1]

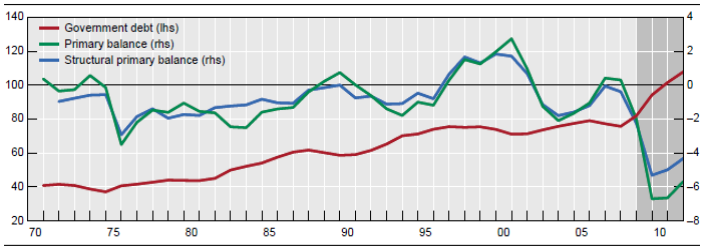
	Fiscal balance			Structural balance[2]			General government debt[3]		
	As a percentage of GDP								
	2007	2010	2011	2007	2010	2011	2007	2010	2011
Austria	–0.7	–5.5	–5.8	–1.4	–3.3	–3.6	62	78	82
France	–2.7	–8.6	–8.0	–3.5	–6.8	–6.3	70	92	99
Germany	0.2	–5.3	–4.6	–0.8	–4.0	–3.7	65	82	85
Greece	–4.0	–9.8	–10.0	–4.5	–6.9	–6.8	104	123	130
Ireland	0.2	–12.2	–11.6	–1.3	–9.0	–9.0	28	81	93
Italy	–1.5	–5.4	–5.1	–2.2	–2.6	–2.8	112	127	130
Japan	–2.5	–8.2	–9.4	–3.4	–7.4	–9.0	167	197	204
Netherlands	0.2	–5.9	–5.3	–0.6	–3.6	–3.1	52	77	82
Portugal	–2.7	–7.6	–7.8	–2.8	–6.1	–6.8	71	91	97
Spain	1.9	–8.5	–7.7	1.6	–5.2	–4.5	42	68	74
United Kingdom	–2.7	–13.3	–12.5	–3.4	–10.5	–9.9	47	83	94
United States	–2.8	–10.7	–9.4	–3.1	–9.2	–8.2	62	92	100
Asia[4]	0.1	–3.5	–3.6	…	…	…	37	40	41
Central Europe[5]	3.7	–4.4	–3.9	…	…	…	23	28	29
Latin America[6]	–1.5	–2.4	–2.0	…	…	…	41	37	35

[1] Regional averages calculated as weighted averages based on 2005 GDP and PPP exchange rates. [2] Cyclically adjusted balance. [3] For Argentina, the Philippines and Thailand, central government debt. [4] China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand. [5] The Czech Republic, Hungary and Poland. [6] Argentina, Brazil, Chile and Mexico.

Sources: IMF, *World Economic Outlook* (emerging market economies); OECD, *Economic Outlook* (advanced economies).

Government gross debt and primary fiscal balance in industrial economies[1]

As a percentage of GDP



Shaded areas represent forecast.

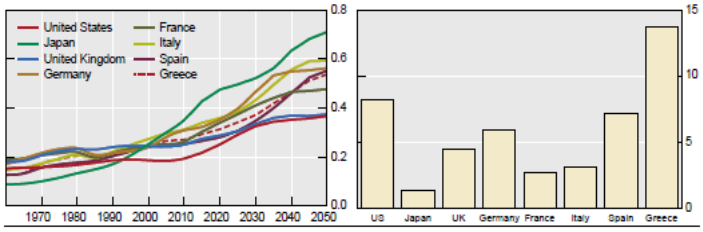
[1] Weighted average based on 2005 GDP and PPP exchange rates of economies cited and data availability; Australia, Austria, Belgium, Canada, Denmark, France, Finland, Germany, Greece, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom and the United States.

Sources: OECD; authors' calculations.

Projected population structure and age-related spending

Old-age population (ratio to working-age population)[1]

Estimated increase in age-related government expenditure from 2011 to 2050[2]



[1] Working-age population is between 15 and 64 years of age. [2] In percentage points of GDP.

Sources: IMF, World Economic Outlook, April 2007; UN Secretariat; European Commission; Congressional Budget Office; authors' calculations.

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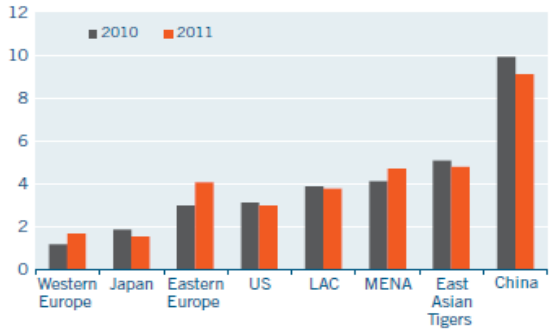
GLOBAL ECONOMIC OVERVIEW

Real GDP Growth Forecasts for 2010–2011

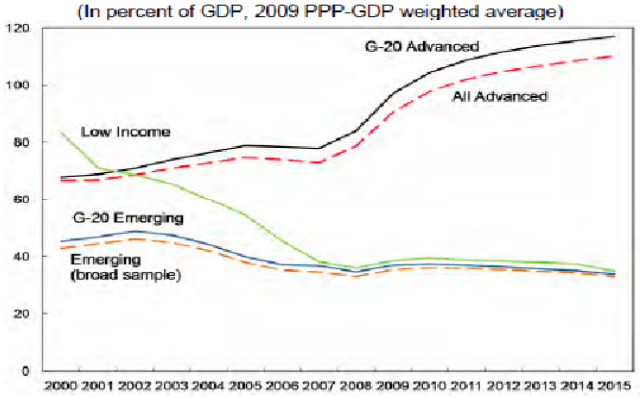
Annual Real GDP Growth Rate



Note: Western Europe comprises Euro Zone countries, Denmark, Sweden, UK, Norway, and Switzerland. Source: Consensus Forecasts (December 2009 and March 2010), and Bloomberg.

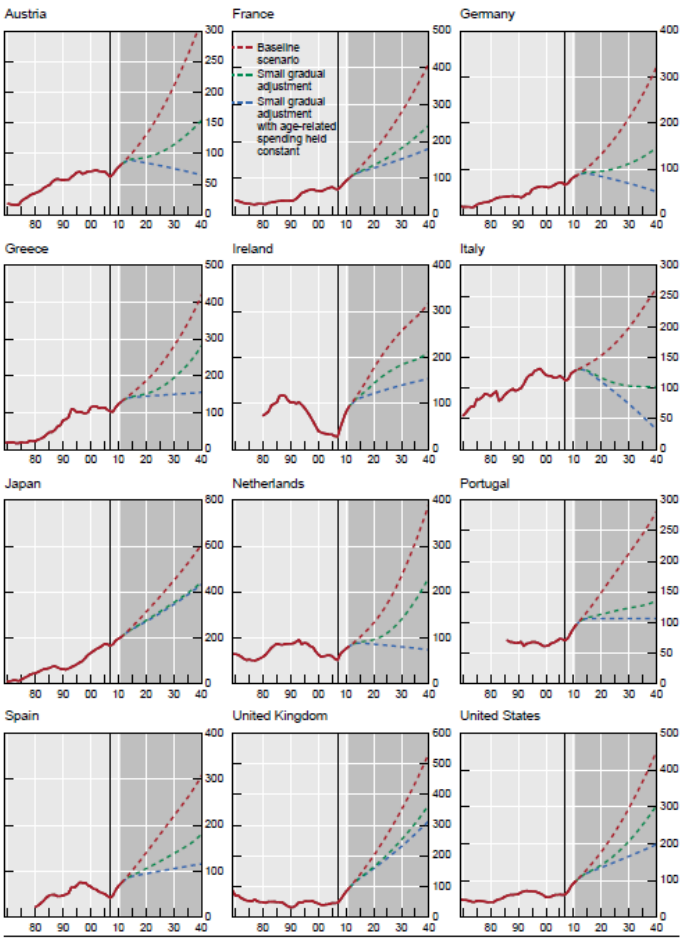
General Government Gross Debt Ratios

(In percent of GDP, 2009 PPP-GDP weighted average)



Source: IMF staff estimates based on the April 2010 *WEO* projections.

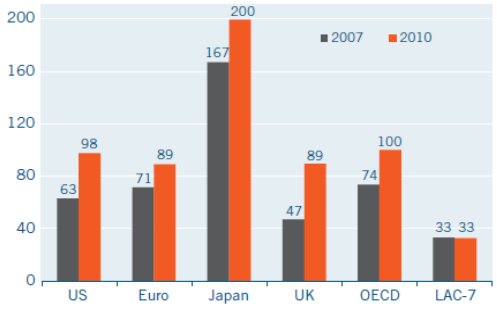
Public debt/GDP projections



Sources: OECD; authors' projections.

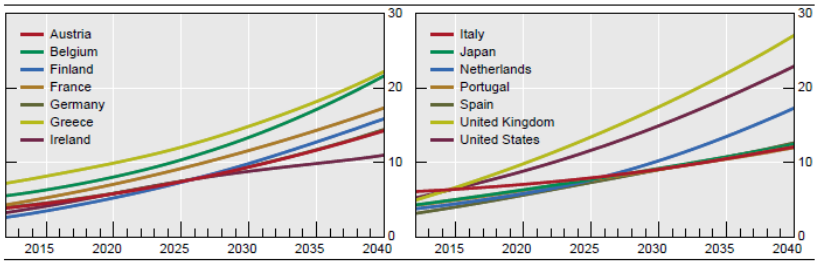
Gross Nominal Liabilities

% of GDP



Projected interest payments as a fraction of GDP

In per cent



Sources: OECD; authors' projections.

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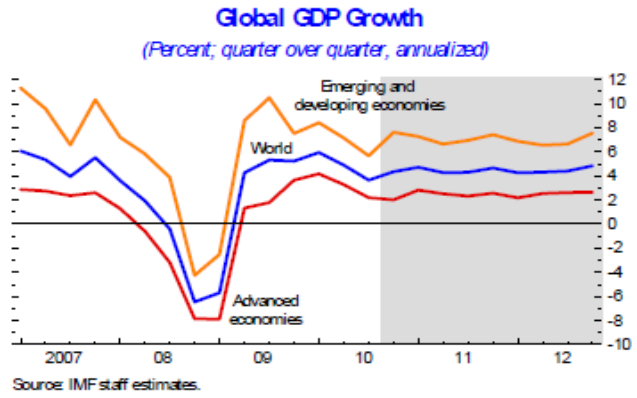
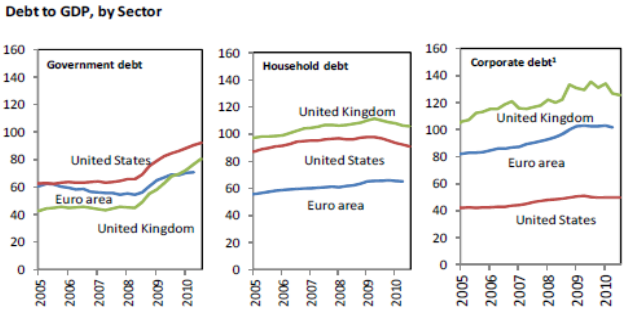
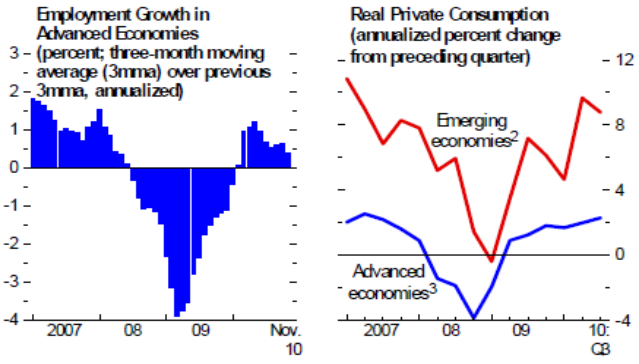
GLOBAL ECONOMIC OVERVIEW



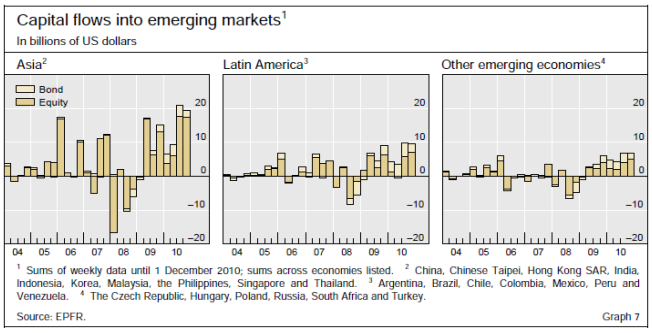
Source: IMF staff estimates.



Sources: Haver Analytics; and IMF staff calculations.
[1]Corporate debt refers to non-financial corporate loans and bonds issued.

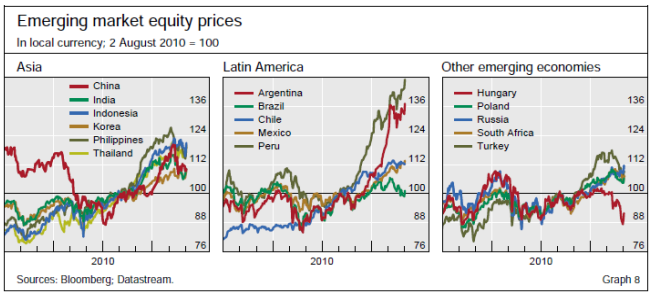


Sources: Haver Analytics; and IMF staff calculations.
[1]Not all economies are included in the aggregations. Aggregates are computed on the basis of purchasing-power-parity (PPP) weights unless noted otherwise.
[2]Argentina, Brazil, Bulgaria, Chile, China, Colombia, Estonia, Hungary, India, Indonesia, Latvia, Lithuania, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Romania, Russia, South Africa, Thailand, Turkey, Ukraine, and Venezuela.
[3]Australia, Canada, Czech Republic, Denmark, euro area, Hong Kong SAR, Israel, Japan, Korea, New Zealand, Norway, Singapore, Sweden, Switzerland, Taiwan Province of China, United Kingdom, and United States.
[4]PPP-weighted averages of metal products and machinery for euro area, plants and equipment for Japan, plants and machinery for the United Kingdom, and equipment and software for the United States.

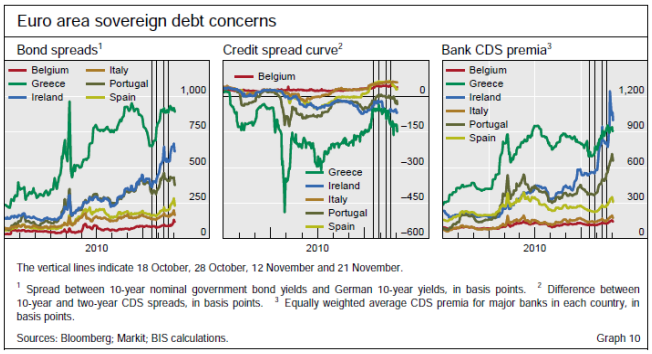


[1] Sums of weekly data until 1 December 2010; sums across economies listed. [2] China, Chinese Taipei, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand. [3] Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. [4] The Czech Republic, Hungary, Poland, Russia, South Africa and Turkey.

Source: EPFR. Graph 7



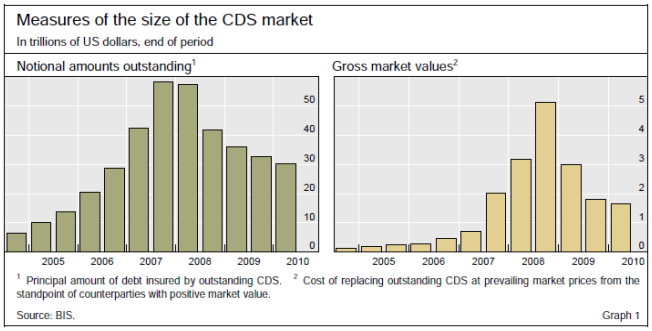
Sources: Bloomberg; Datastream. Graph 8



The vertical lines indicate 18 October, 28 October, 12 November and 21 November.

[1] Spread between 10-year nominal government bond yields and German 10-year yields, in basis points. [2] Difference between 10-year and two-year CDS spreads, in basis points. [3] Equally weighted average CDS premia for major banks in each country, in basis points.

Sources: Bloomberg; Markit; BIS calculations. Graph 10


Measures of the size of the CDS market
In trillions of US dollars, end of period
Notional amounts outstanding1
Gross market values2

[1] Principal amount of debt insured by outstanding CDS. [2] Cost of replacing outstanding CDS at prevailing market prices from the standpoint of counterparties with positive market value.

Source: BIS. Graph 1

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GLOBAL ECONOMIC OVERVIEW

Foreign exposures to Greece, Ireland, Portugal and Spain, by bank nationality

End-Q2 2010; in billions of US dollars

	Type of exposures	Bank nationality									
		DE[1]	ES[2]	FR[3]	IT	OEA[2]	GB	JP	US	ROW	Total
Greece	Public sector	22.6	0.6	17.8	2.7	15.0	2.9	1.0	1.5	1.0	65.0
	+ Banks	4.7	0.0	0.8	0.9	1.3	1.6	0.5	1.2	1.2	12.3
	+ Non-bank private	9.6	0.2	38.7	1.7	12.4	7.6	0.7	4.5	3.8	79.2
	+ Unallocated sector	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1
	= Foreign claims	36.8	0.9	57.3	5.3	28.8	12.1	2.2	7.2	6.1	156.6
	+ Other exposures[4]	28.6	0.5	25.7	1.6	2.8	4.8	0.1	29.0	2.4	95.5
	= Total exposures	65.4	1.3	83.1	6.8	31.6	17.0	2.3	36.2	8.5	252.1
Ireland	Public sector	3.4	0.2	6.1	0.8	3.2	3.5	1.6	1.5	1.8	22.2
	+ Banks	47.5	3.3	18.9	2.9	8.8	31.1	1.6	19.8	11.7	145.7
	+ Non-bank private	87.7	10.5	18.5	10.7	44.7	97.0	17.6	35.9	26.1	348.5
	+ Unallocated sector	0.0	0.0	0.0	0.3	0.2	0.0	0.0	0.0	1.0	1.5
	= Foreign claims	138.6	14.0	43.6	14.6	56.9	131.6	20.8	57.2	40.5	517.9
	+ Other exposures[4]	47.9	3.7	33.7	10.0	7.3	55.9	1.2	51.0	18.2	228.9
	= Total exposures	186.4	17.7	77.3	24.7	64.2	187.5	22.0	108.3	58.8	746.8
Portugal	Public sector	7.4	8.1	14.2	0.8	7.5	2.3	1.2	0.8	1.6	44.0
	+ Banks	17.1	7.0	13.8	2.5	5.0	5.6	0.3	1.1	0.8	53.2
	+ Non-bank private	12.7	62.7	13.3	1.3	6.6	14.4	0.8	1.4	1.5	114.6
	+ Unallocated sector	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	= Foreign claims	37.2	77.8	41.3	4.6	19.1	22.2	2.2	3.3	4.0	211.8
	+ Other exposures[4]	7.0	20.6	7.2	3.0	2.1	6.8	0.4	32.3	1.5	80.8
	= Total exposures	44.3	98.3	48.5	7.6	21.2	29.0	2.6	35.6	5.5	292.6
Spain	Public sector	26.2	...	40.4	2.5	16.2	9.2	8.8	4.5	3.4	111.2
	+ Banks	81.1	...	50.2	9.2	48.2	28.8	4.4	23.8	9.6	255.3
	+ Non-bank private	74.4	...	74.0	13.9	87.2	66.7	8.7	24.2	10.5	359.5
	+ Unallocated sector	0.0	...	0.0	0.2	0.1	0.0	0.0	0.0	0.4	0.7
	= Foreign claims	181.6	...	164.6	25.9	151.7	104.7	21.9	52.5	23.9	726.7
	+ Other exposures[4]	34.9	...	36.7	11.4	12.4	31.8	3.2	120.4	12.3	263.0
	= Total exposures	216.6	...	201.3	37.2	164.1	136.5	25.1	172.8	36.2	989.8

DE = Germany; ES = Spain; FR = France; IT = Italy; OEA = other euro area; GB = United Kingdom; JP = Japan; US = United States; ROW = rest of the world.

[1] Foreign claims of German banks on the four countries are on an immediate borrower basis. [2] Exposures of banks headquartered in the respective country are not included, as these are not foreign exposures. [3] Exposures of French banks to the four countries are currently under review and are subject to revisions. [4] Positive market value of derivative contracts, guarantees extended and credit commitments.

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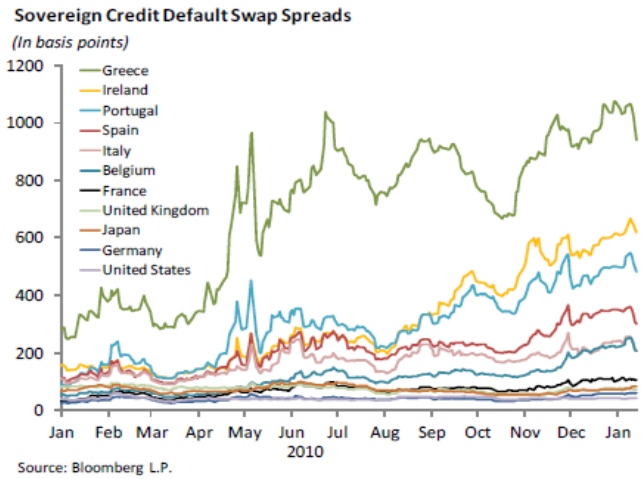
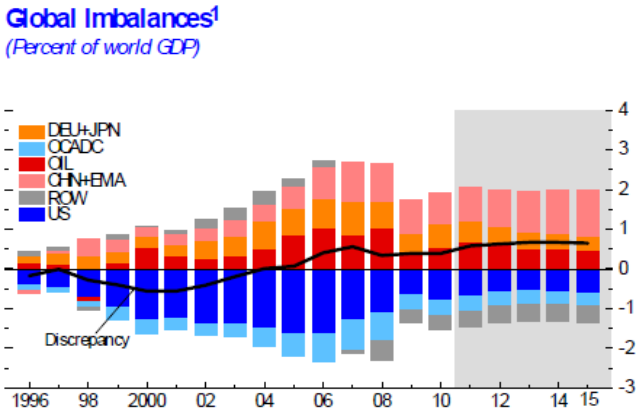
GLOBAL ECONOMIC OVERVIEW

I complete this section with more current data. While the implied volatility of the global equities markets are trending downward, the U.S. market is trending higher and emerging markets are moving sideways with a small prejudice towards the downside.

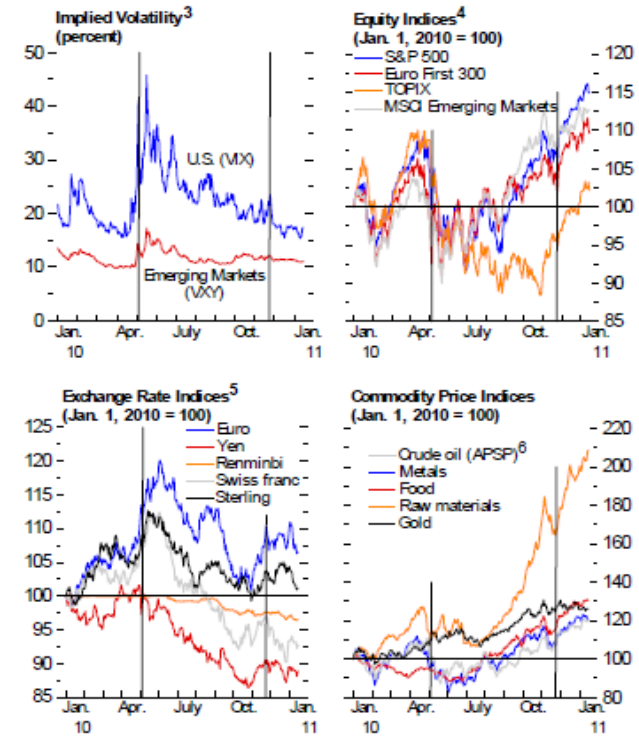
Raw materials leads the surge in commodities pricing, while food, metals and oil trending up. Meanwhile, gold is stalling.

Notably, sovereign default spreads continue their strong upward trend which began in 2007. After setting new highs in January, CDS spreads have made a small correction within an acceptable limit of the bullish trend.





Source: IMF staff estimates.
[1]CHN+EMA: China, Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, and Thailand; DEU+JPN: Germany and Japan; OCADC: Bulgaria, Croatia, Czech Republic, Estonia, Greece, Hungary, Ireland, Latvia, Lithuania, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Turkey, and United Kingdom; OIL: Oil exporters; ROW: rest of the world; US: United States.



Sources: Bloomberg Financial Markets; Datastream; and IMF staff calculations.
[1]Vertical lines on each panel correspond to May 10 and November 30, 2010.
[2]ECB = European Central Bank; LIBOR = London interbank offered rate; OIS = Overnight index swap.
[3]VIX = Chicago Board Options Exchange Market Volatility Index, a measure of the implied volatility of options on the S&P 500 index; VXY = JPMorgan emerging markets implied volatility index, a measure of the aggregate volatility in currency markets.
[4]TOPIX = Tokyo stock price index; MSCI = emerging markets stock price index.
[5]Bilateral exchange rates against the U.S. dollar (increase denotes depreciation).
[6]APSP = average petroleum spot price.

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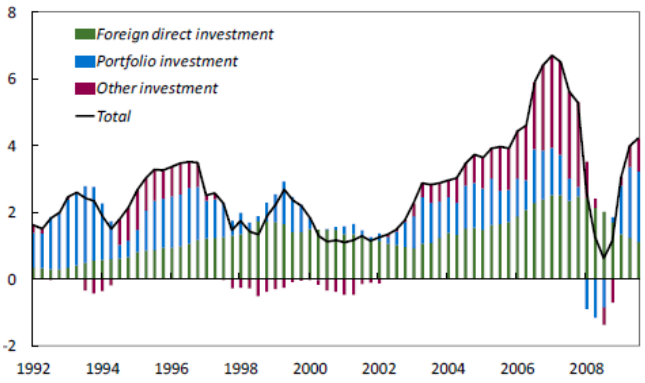
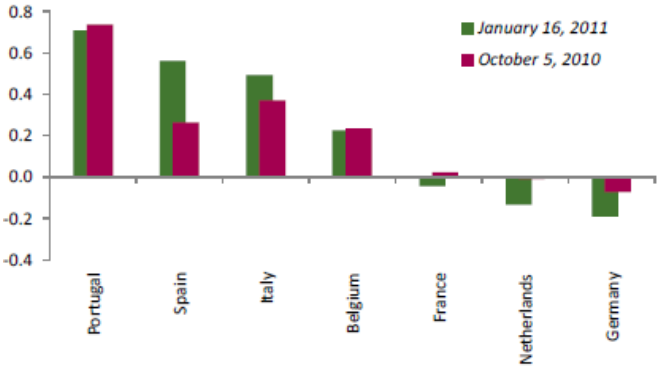
GLOBAL ECONOMIC OVERVIEW

Capital Flows to Emerging Markets
(Net liabilities, percent of aggregate GDP, 4-quarter moving average)

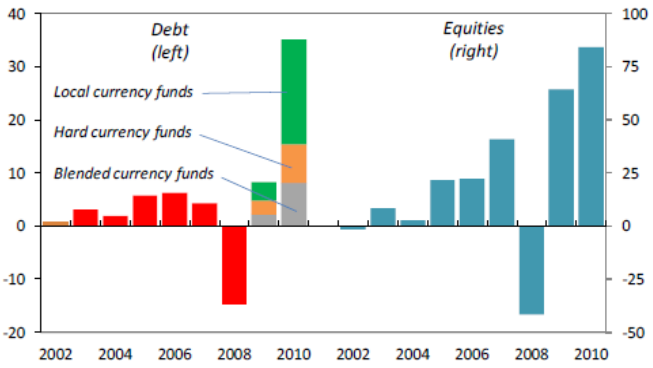


Sources: IMF, International Financial Statistics; Haver Analytics; and IMF staff estimates.

Ten-Year Government Bond Correlation with Average of Greece and Ireland
(3-month correlation coefficient)

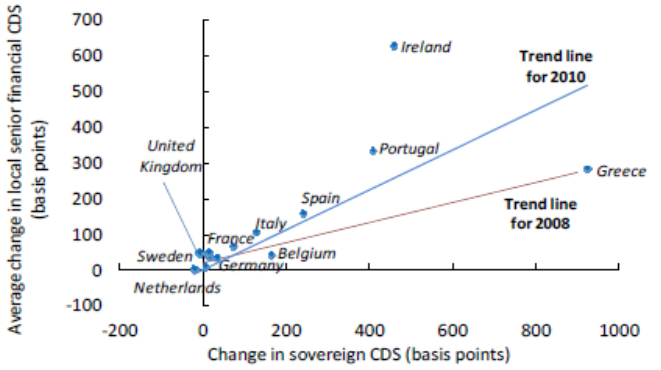


Annual Retail Flows to Emerging Market Debt and Equity Mutual Funds
(In billions of U.S. dollars)



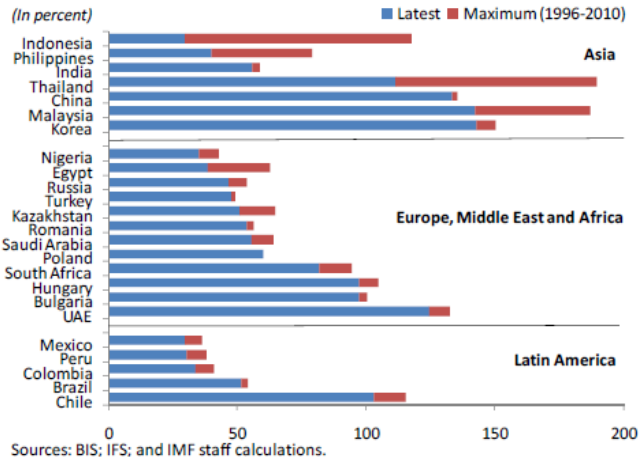
Sources: EPFR; and IMF staff estimates.

Sovereign and Bank Credit Default Swap Spreads[1]



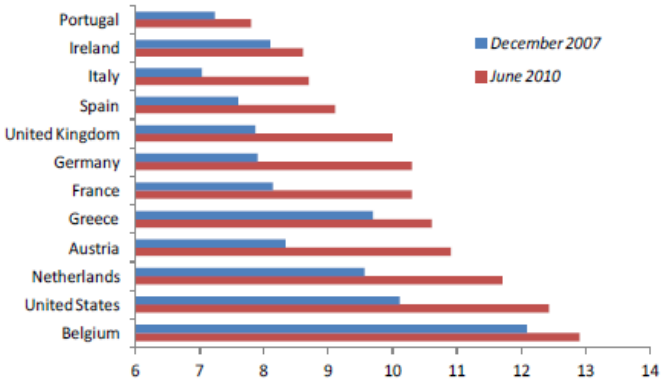
Sources: Bloomberg L.P.; and IMF staff estimates.
[1]January 2010 to December 2010. Data points not labeled are for Austria, Denmark, and Norway.

Non-Financial Private Sector Debt to GDP
(In percent)



Sources: BIS; IFS; and IMF staff calculations.

Banking System Tier 1 Capital Ratios
(In percent)



Sources: EU Consolidated Banking Data; and Federal Deposit Insurance Corporation.

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GLOBAL ECONOMICS—JAPAN

On January 27th, 2011 S&P downgraded Japan's long-term sovereign debt rating to AA-minus. This came as a surprise to some, but only because the credit-rating agencies are seen as allies to the U.S. and their closest economic partners.

Several months ago, you may recall that I mentioned my own ideas regarding how I felt things would play out over the next few years. Basically, I stated that **much of the entire world is filled with economic problems. Yet, the markets tend to prop up one major issue at a time. As a result, we re likely to experience a pinball action throughout the globe over the never several years, as each region moves up in line for its turn to be scrutinized by investors.**

We experienced a similar sequence of events early on in the financial crisis. As you will recall, subprime lenders were the early focus. Later, the focus became the bond insurers. Later it was the GSEs. Next came the peak of the financial crisis. Since that time, the big focus in the U.S. has been on the lingering real estate and job market. But many other problems remain. Just over one year ago I detailed the severe fiscal challenges faced by state and local governments. While this problem continues to worsen, it has not taken center stage.

We are seeing the same thing across the globe. First, the focus was on U.S. banks. Next, the focus shifted to European banks. Now the focus is on the European sovereign crisis. However, all of the other problems remain largely unresolved.

Is Japan's debt downgrade large enough to divert attention from Europe's problems?

Not likely. Thus far, the Yen has continued to gain against the dollar. This year, Japan's government debt is expected to top 200% of GDP for a total of nearly $11 trillion. However, we are not likely to see panic-selling of Japanese bonds, driving yields to levels that would surely add to current forces that have maintained sluggish growth.

Recall that Japan is unique in that about 97% of its sovereign debt is held by domestic investors and the Japanese central bank.

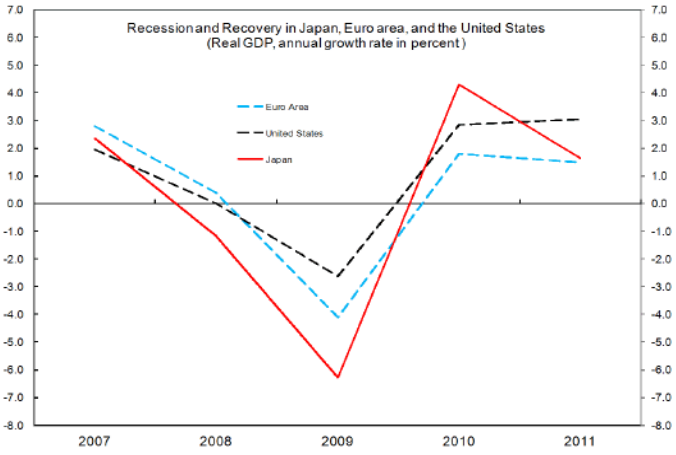
That said, Japan will eventually take the spotlight as the world begins to focus on its problems. But for now, investors have other fish to fry.

After meeting recently, Japan's central bank left interest rates unchanged at 0.0 to 0.1%. As many of you know, Japan has been fighting variable periods of deflation over the past twenty years. And I don't see things changing anytime soon. However, the Bank of Japan expects deflation to end sometime in 2012. Of course, the Bank has been making this same prediction now for many years with no success.

Despite all of the negativity regarding Japan's economic problems that plasters the media, the fact is that it experienced a relatively rapid recovery; that is, if we adhere to the "official" definition of recovery.

Japan's economy contracted more but also rebounded faster than any other G7 economy in 2009-10.

This superficial definition of "recovery" has characterized the U.S as having progressed reasonably despite the lack of real improvement in the job and housing markets. U.S. officials have been hyping up every ounce of positive economic data so as to reaffirm their case that the recession ended in June 2009 and a recovery is progressing. But the reality is much different.



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GLOBAL ECONOMICS—JAPAN

Likewise, Japan's recovery is beginning to lose steam. While considerable improvement was seen through most of 2010, things had slowed in the last few months of the year as its economic stimulus ran out.

Japan's much important export trade has since faded due to the appreciation in the yen, while new forecasts released by the IMF on January 25, 2011 predict **GDP growth will be squeezed down from an impressive 4.3% in 2010 to 1.6% in 2011.**

Japan's economy is far less resilient than that of the U.S., due to chronic deflation and one of the highest sovereign debt ratios in the world.

With most of its monetary and fiscal policies having been exhausted, Japan faces the risk of extending its deflation for many years to come.

Like most nations, Japan also faces the harsh economic consequences of unbalanced demographics in coming years. The increasing trend of demographic imbalance faced by Japan is one of the most dire in the world. The nation is already witnessing a shrinking labor supply. This in part accounts for its relatively low unemployment rate.

In order to stand a chance to resolve its fundamental problems, Japan must identify further options in order to utilize the trend of greater trade liberalization offered through the Transpacific Partnership.

Japan must also invest heavily in its economy to facilitate greater business opportunities and entrepreneurial opportunities. But this is only a small piece of the puzzle.

Japan must also work to gradually reduce its public debt, all while balancing needed investment and other measures needed to provide long-term improvement. As you can imagine, a very delicate balance will be required in order to achieve these objectives.

Regardless how well it is able to execute a long-term turn-around, very little can be done to alter Japan's shrinking labor force. As fewer workers enter the economy, Japan's growth will depend more on investment and productivity. Thus, Japan must focus on technological investments to help make up the gap as its labor force continues to decline. The best way to achieve this is to promote more venture capital investment and provide further incentives for entrepreneurs.

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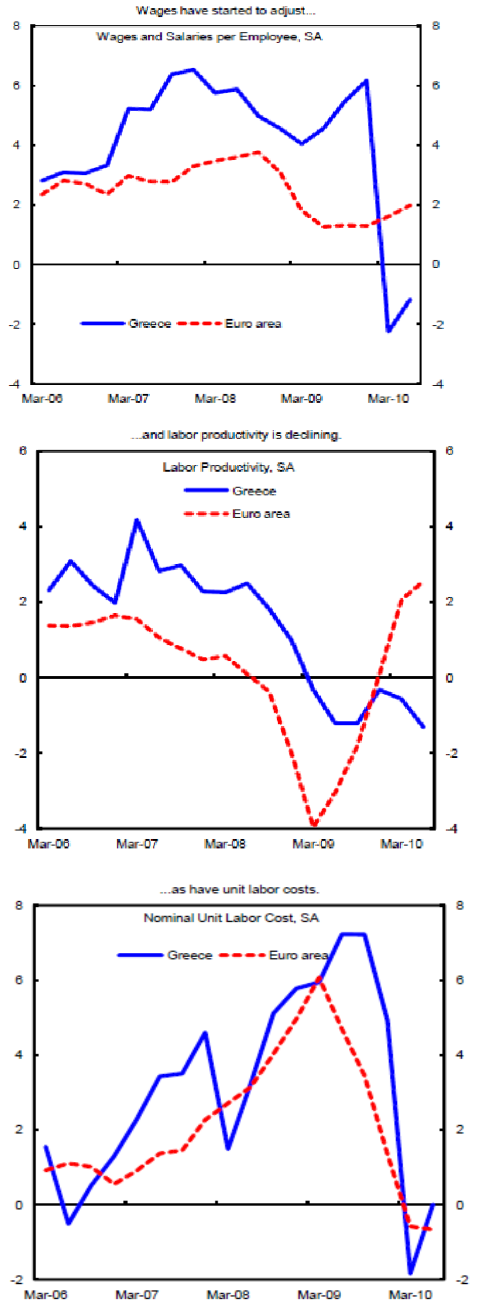
GLOBAL ECONOMICS—GREECE

Here, I present some important data showing the challenges faced by Greece.

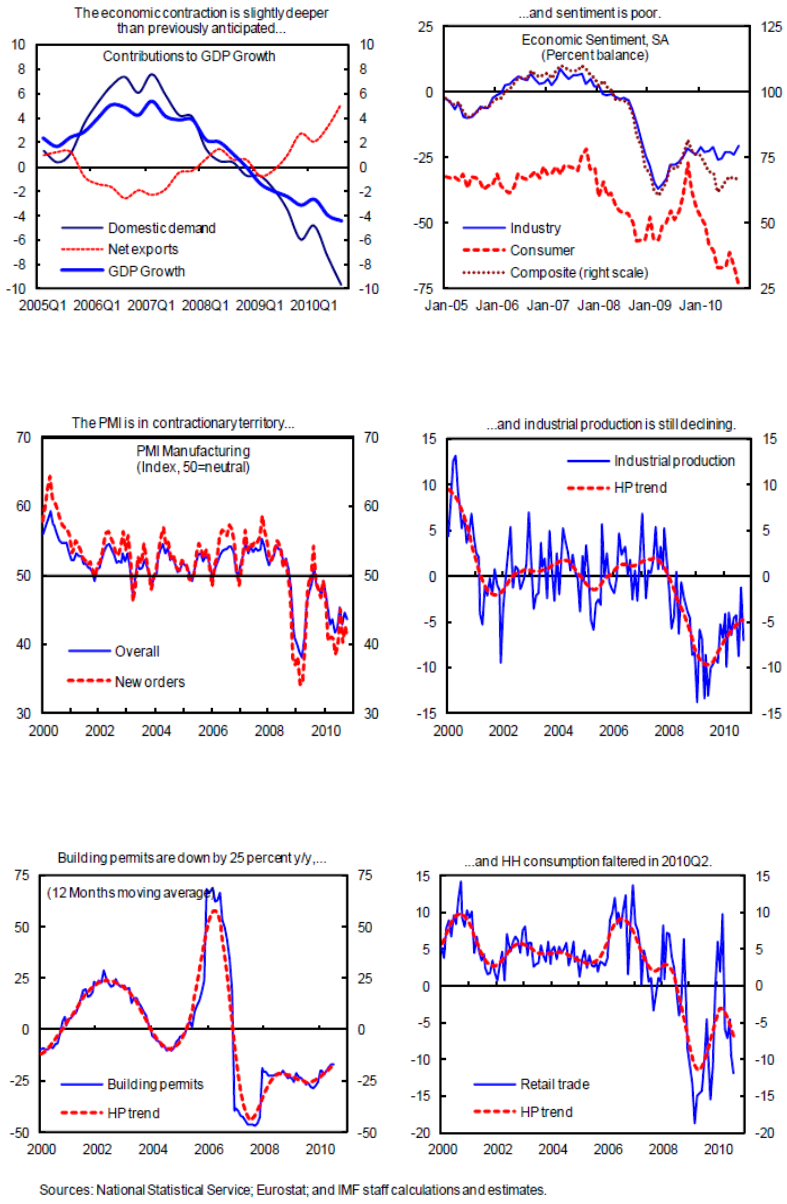
Greece: Competitiveness Indicators, 2006–10

(Year-on-year percent change, unless otherwise indicated)



Greece: Selected Economic Indicators, 2005–10

(Year-on-year percent change, unless otherwise indicated)



Sources: National Statistical Service; Eurostat; and IMF staff calculations and estimates.

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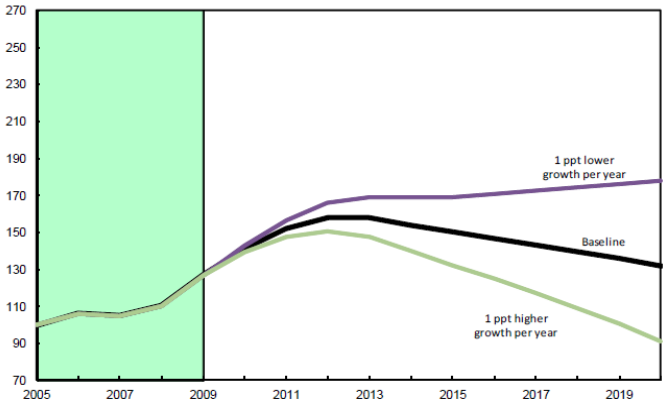
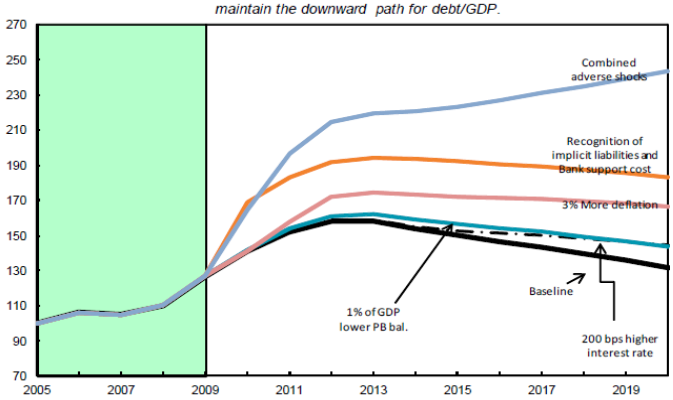
GLOBAL ECONOMICS—GREECE

Greece: Public Debt Sustainability Analysis (percent of GDP)

The pace of real GDP growth remains critical for ensuring falling debt/GDP ratios....



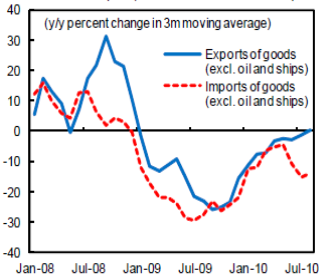
All other shocks (except a combined adverse shock) would affect the level of debt, but maintain the downward path for debt/GDP.


Combined adverse shocks
Recognition of implicit liabilities and Bank support cost
3% More deflation
Baseline
1% of GDP lower PB bal.
200 bps higher interest rate

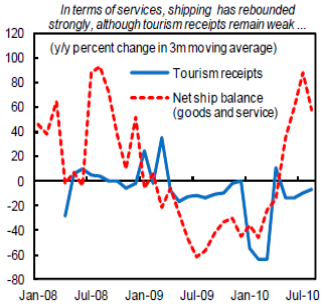
Source: IMF staff projections based on data provided by the authorities.

Greece: Balance of Payments

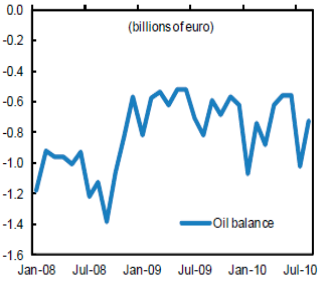
The non-oil trade balance is improving, reflecting a contraction of imports, as well as a stabilization of exports.



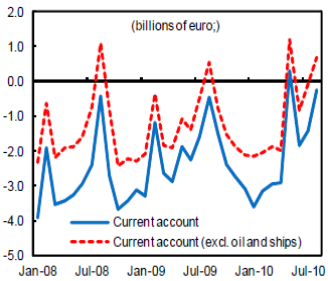
In terms of services, shipping has rebounded strongly, although tourism receipts remain weak ...



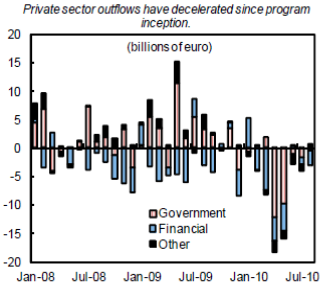
... but higher oil prices have worsened the oil balance.



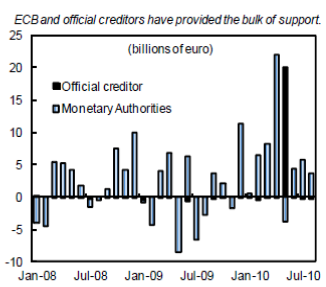
Overall, the current account is improving.



Private sector outflows have decelerated since program inception.



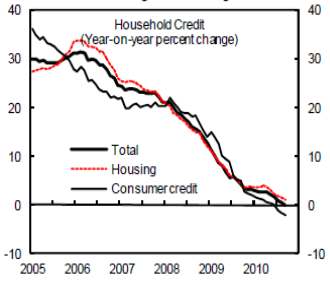
ECB and official creditors have provided the bulk of support.



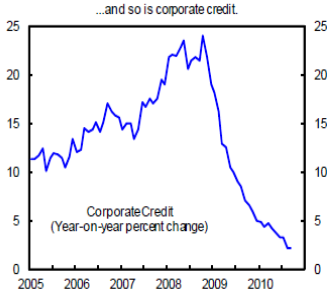
Sources: Bank of Greece; and IMF staff calculations.

Greece: Money and Banking Indicators, 2005–10

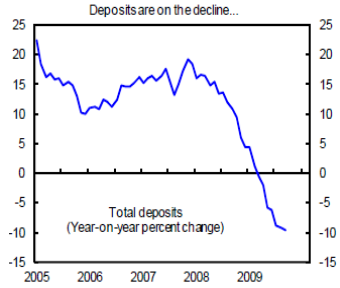
HH credit growth is slowing...



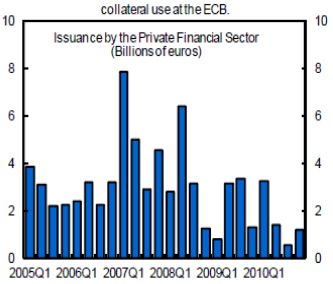
...and so is corporate credit.



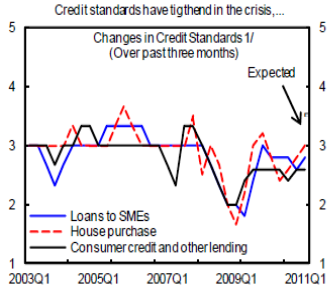
Deposits are on the decline...



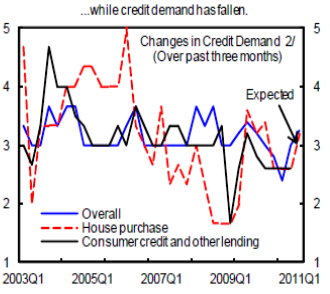
...but banks have issued some debt in 2010 for collateral use at the ECB.



Credit standards have tigthend in the crisis,...



...while credit demand has fallen.



Sources: National Statistical Service; Bank of Greece; Bloomberg; ECB; and IMF staff calculations.

1/ Scale: 1= tightened considerably; 2= tightened somewhat; 3=remain unchanged; 4=eased somewhat 5= eased considerably

2/ 1= decreased considerably; 2= decreased somewhat; 3=remain unchanged; 4=increased somewhat; 5= increased considerably

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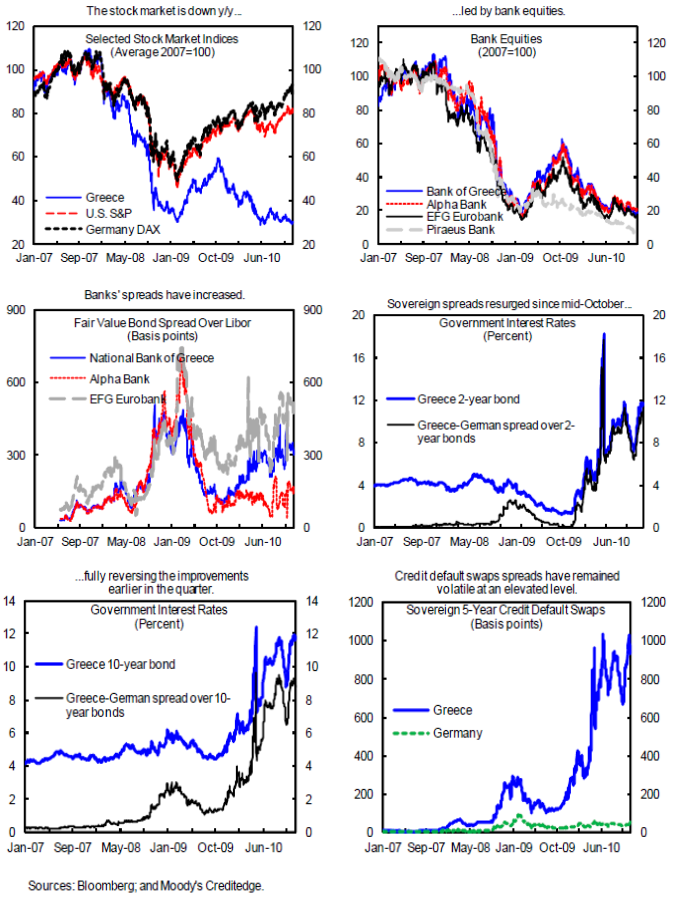
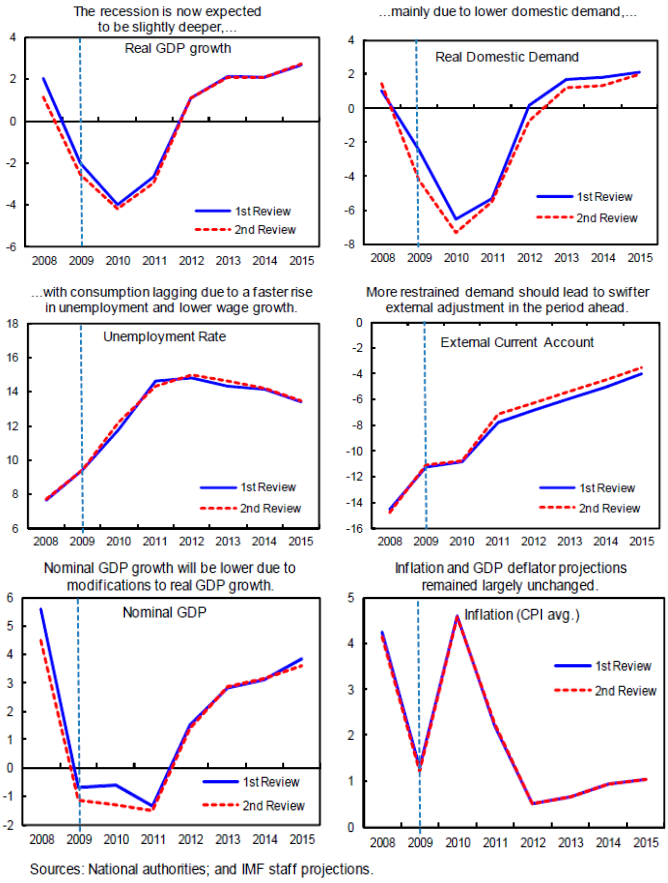
GLOBAL ECONOMICS—GREECE

Greece: Financial Indicators, 2007–10



Sources: Bloomberg; and Moody's Creditedge.

Greece: Revised Macro Projections
(Year-on-year percent change)


The recession is now expected to be slightly deeper,...
Real GDP growth
...mainly due to lower domestic demand,...
Real Domestic Demand
...with consumption lagging due to a faster rise in unemployment and lower wage growth.
Unemployment Rate
More restrained demand should lead to swifter external adjustment in the period ahead.
External Current Account
Nominal GDP growth will be lower due to modifications to real GDP growth.
Nominal GDP
Inflation and GDP deflator projections remained largely unchanged.
Inflation (CPI avg.)
1st Review
2nd Review
2008 2009 2010 2011 2012 2013 2014 2015

Sources: National authorities; and IMF staff projections.

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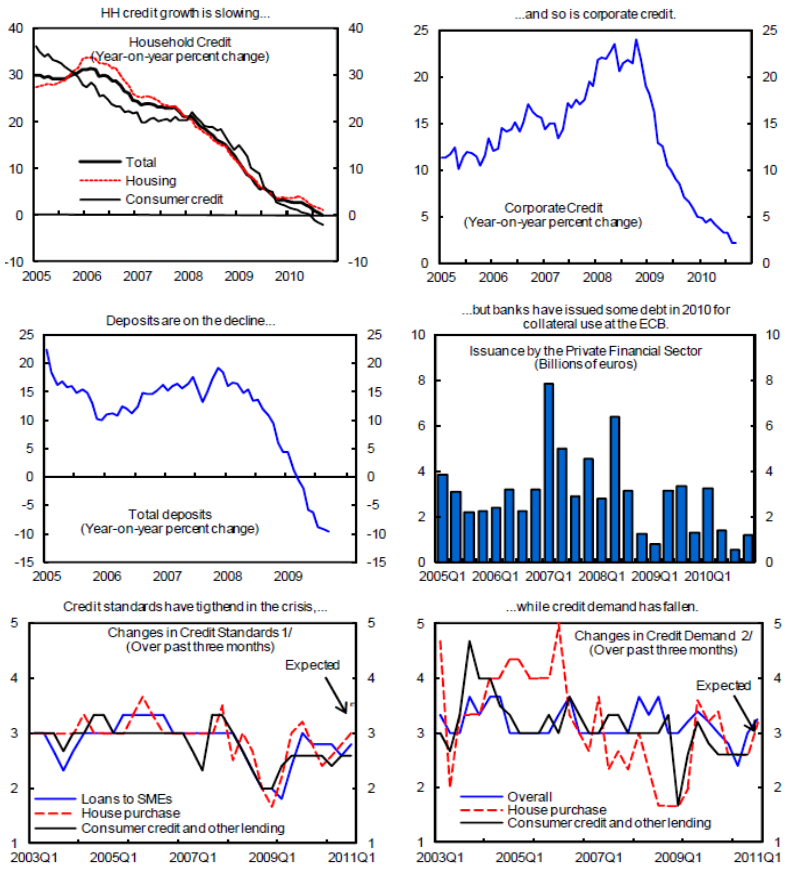
GLOBAL ECONOMICS—GREECE

Deutsche Bank (DB) has a pretty heavy exposure to Greece. In July 2010, the bank said it had net exposure of 1.1 billion euros to Greece, 8.1 billion euros to Italy, and 1 billion euros to Spain at the end of March, more than double figures it had previously given.

Despite the fact that shares have been moving up lately, I would be using this recent rise as a selling opportunity.

Greece: Money and Banking Indicators, 2005–10



Sources: National Statistical Service; Bank of Greece; Bloomberg; ECB; and IMF staff calculations.
1/ Scale: 1= tightened considerably; 2= tightened somewhat; 3=remain unchanged; 4=eased somewhat 5= eased considerably
2/ 1= decreased considerably; 2= decreased somewhat; 3=remain unchanged; 4=increased somewhat; 5= increased considerably

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EUROPE'S DEFLATIONARY FUTURE

In the past I have detailed the problems in Europe, the U.S. and Japan. While I have highlighted the opportunities in China, Brazil and India, I have also discussed the risks. Here, I wanted compare some macro variables of the U.S. with the EU-15. (1)

The purpose of this discussion is to shed additional light on the longer-term picture of each of these economic powerhouses so that we can obtain a reasonable picture of future potential austerity measures each economy faces. You should review Volumes 15 and 18 discussing global pension risk.

[If you do not have these volumes and wish to purchase them or any others, please contact us. We sell each back issue at $29.95 or if you want all back issues, we sell them at $22.95 each].

First, let's look at some broad comparisons between the U.S. and EU economy.

- EU per capita GDP is 24% less than in the U.S.
- 2009 productivity is 15% lower in the EU-15 than in the U.S.
- 70% of Europe's productivity gap from 1995-2005 is from local services.
- On average, Europeans works 5 weeks less than Americans (see chart on p.20).
- 28% of world GDP in 2009 came from EU-27 (all EU members). See chart on p.20.
- From 1995-2005, manufacturing drove 37% of productivity growth in the EU-15.
- >100% of the 1995-2005 net job growth in the EU-15 came from services.
- 24 million net new jobs were created in the EU-15 between 1995-2008.
- Labor market participation by 55 to 64 year olds in Sweden is 74%.
- Labor market participation by 55 to 64 year olds in Italy is 37%.

In previous issues of the newsletter I have detailed that the problems faced by the EU are variable. The more advanced nations of the EU (Northern Europe) general face less severe challenges for future growth. In contrast, emerging EU nations (Southern Europe) generally face very severe challenges. However, because the EU is linked by a central currency as well as a system of commerce and trade, the contingent liabilities found in emerging Europe continue to be felt by more advanced European nations.

Overall, the high debt and deficit levels seen in the EU cannot be sustained. This means they will need to be slashed. As a result, public funds will be unavailable to stimulate growth in the EU for some time to come. The U.S., UK and Japan face a similar problem. However, for now the situation in the EU is more dire due to short-term financing requirements.

Perhaps the most troublesome issue faced by the EU is that of disparities found in labor costs and current account balances (see charts on pp 19-20). I discussed this in the past. While austerity measures can address current account balances, the large disparity in labor costs presents a more severe problem. I detailed this chronic relationship back in the very first issue of this newsletter (June 2009) well before the Greek sovereign debt crisis had materialized. In summary, **I basically stated that due to the differences in infrastructure between advanced nations like Germany and emerging nations like Greece, there would be harsh economic disparities.**

There is no clear solution to this. At best, more centralized and coordinated policies by the EU could address this, but at what cost? EU member nations will be required to sacrifice even more of their sovereignty, and I do not expect this to be accepted well. Furthermore, the EU does not have the funds to move forward with an infrastructure project on the scale that is required to ensure pre-crisis growth.

(1) The EU-15 represented 88% of the EU-27 GDP in purchasing power parity in 2009 and 98% of the eurozone.

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EUROPE'S DEFLATIONARY FUTURE

Combined with the very sluggish economy, the **austerity measures that must be taken in the EU (and soon within the U.S., UK and Japan) threaten to reign in a very long period of deflation.**

However, I would not expect deflation to present as much of a problem in the U.S. due largely to the dollar-oil link. This enables the Federal Reserve can keep printing dollars to pump up the U.S. economy.

While the dollar-oil link enables the U.S. to export a large portion of the inflation created by the Fed, China serves as the primary recipient. Moreover, Brazil is also exposed to a disproportionate amount of inflation exported from the U.S. due to the strong economic link between China and Brazil.

Many pundits have been discussing the possibility of a Japan-like deflationary period in the U.S. These individuals are misguided. They fail to understand the advantages provided by the dollar-oil link.

The Federal Reserve will keep printing money as its solution to the current depression. This will be an inflationary depression as detailed in America's Financial Apocalypse. A Japan-style deflationary period is much more likely to hit the EU.

Let me discuss why I feel the EU is likely to be headed for a long period of deflation. First, as you recall from the Global Pension (Parts 1 and 2), global demographics dictate a smaller percentage of workers versus retired over the next few decades.

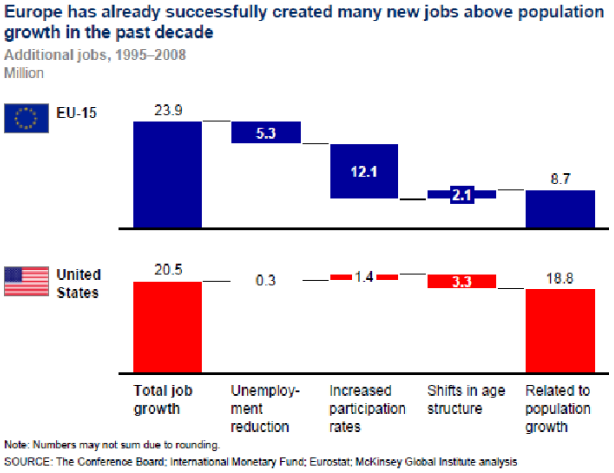
McKinsey has estimated that total EU GDP will be reduced annually by 0.4% over the next 20 years from the shift in demographics alone. According to European Commission estimates, **Europe's aging population will require an additional expenditure equivalent to 3% of GDP by 2035. (2)**

In the ten years prior to the global economic crisis, Europe's per capital GDP growth was similar to that of the U.S. However, as I discussed in Volume 14 (July 2010, page 32) of the newsletter, in the mid-1990s, as emerging European nations entered the EU, current account deficits began to rise (see next page for this discussion).

As the chart below shows, since the mid-1990s Europe has been able to create a large number of jobs. In fact, **while the vast majority of job growth in the U.S. was due to population growth, the main contributor of job growth in Europe was due to an increase labor force participation.**

In other words, the majority of job growth in the U.S. from 1995 to 2008 was restricted to proportionate population growth. Meanwhile, during this same period job growth in Europe was the result of more individuals looking for work.

Job growth due to population growth is not real job growth. In contrast, job growth due to increased participation rates indicates that the capacity to create jobs was there. This implies real job growth.



(2) 2009 Ageing Report: Economic and Budgetary Projections for the EU-27 Member States (2008-2060), European Commission, 2009.

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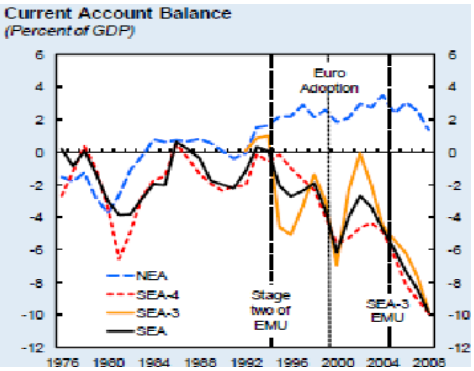
EUROPE'S DEFLATIONARY FUTURE

According to official data from a variety of sources, the current accounts in seven nations within Southern Europe (i.e. Southern Euro Area, SEA) have imploded since the mid-1990s. For instance, in 1994, these nations maintained an overall average current account balance (which can be likened to an annual trade surplus) to an average deficit of 10% in 2008.[1]

When the current accounts of Northern Europe (the Northern Euro Area, NEA) are examined, eight nations have accumulated current account surpluses over the same period.[2]

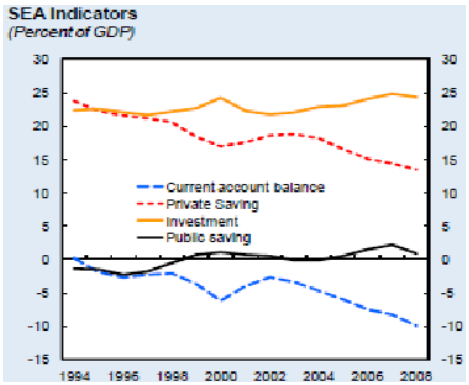


What can explain this rapid demise in SEA economies?

Numerous sources including (even) the IMF and other economic organizations have acknowledged that the decline in the current accounts of SEA countries coincided with their joining the European Monetary Union (EMU) and continued after their subsequent adoption of the euro.

Over the 1994–2008 period, the deterioration in current accounts coincided with a large decrease in private saving rates and, to a lesser extent, with a rise in investment rates, while public saving actually improved.

Yet, according to the IMF, it was the creation of the EMU and, especially, the introduction of the euro, that drove the declines in current accounts by allowing countries to maintain their investment levels above what could be financed from lower domestic saving.



According to the IMF…

"Hence, economic integration improved access to the international pool of saving, but it did not necessarily make it optimal or sustainable.

Even in countries in which an increase in investment played a more important role in the current account deterioration (Spain and Slovenia), most of the increase took place in less productive nontradables sectors, such as construction.

Although the current global financial crisis has forced some reduction in current account deficits, they are expected to remain high in the medium run as a result of the countries' low productivity and weak competitiveness."

[I addressed this concept in the June 2009 issue, when I made the comparison between Germany and Greece, noting the clear economic disparities due to the vast difference in infrastructure].

Thus, the unionization of Europe has largely been responsible for the current economic problems seen is Greece, Italy, Spain, and other nations. It was doomed from the beginning.

1 The SEA consists of Cyprus, Greece, Italy, Malta, Portugal, Slovenia, and Spain. SEA-4 denotes the four largest SEA countries: Greece, Italy, Portugal, and Spain; the latter three joined the EMU in 1994 and the euro area in 1999, and Greece joined the euro area in 2001. The remaining SEA countries, SEA-3 (Cyprus, Malta, and Slovenia) joined the EMU in 2004 and the euro area in 2007–08. Not included in this analysis is Slovakia, which joined the EMU in 2009.

2 The NEA comprises Austria, Belgium, Finland, France, Germany, Ireland, Luxembourg, and the Netherlands.

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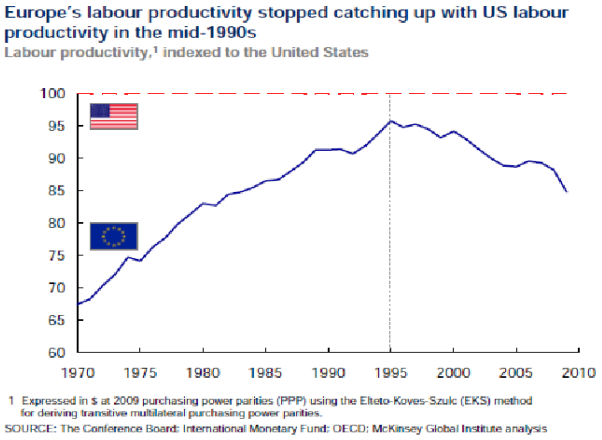
EUROPE'S DEFLATIONARY FUTURE

As the next chart shows, Europe's labor productivity began to slow in the mid-1990s. Given the current economic pressures faced by Europe (based on estimates for labor input) by my estimates, **Europe would need to increase productivity growth by 35% in order to maintain previous its GDP growth.**



Furthermore, if Europe intends to close the 24% gap in per capita GDP (representing $4.5 trillion in total GDP or $11,250 per capita) with the U.S., it would need to increase productivity by more than 50%. This is simply not going to happen. In fact, I am willing to bet that Europe will not have a remote chance of even restoring its previous GDP growth for many, many years.

In the July 2010 issue (Volume 14) you may recall my discussion of the damage to U.S. GDP caused by the real estate banking crisis. I actually posted this section on the website recently. I have included the portion pertaining to this on the next page.

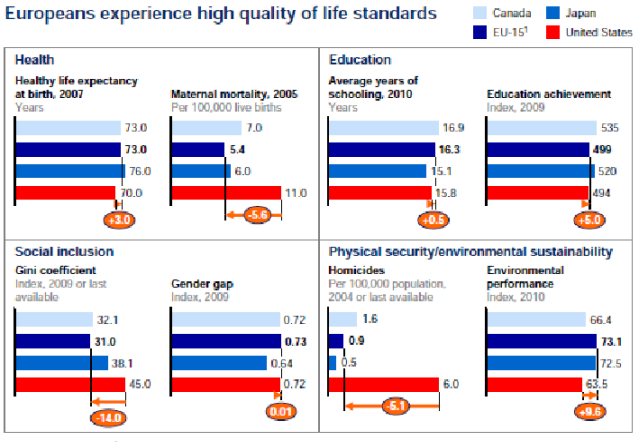
As you might imagine, despite the gains made in labor utilization in Europe, it still remains significantly below that of the U.S. For instance, **the labor force participation for older Europeans aged 55 to 64 is only 51%, while 65% for the same group in the U.S.**

In part, the lower labor force participation seen in Europe stems from their recognition that quality of life means a lot more than being able to afford the latest high-tech gadget, McMansion or trendy luxury auto; a mentality embraced by many Americans.

Europeans enjoy life. They take nice vacations and work fewer hours. The generous social system in Europe has allowed many citizens to maintain this laid back attitude because the government provides vital and costly services like education and healthcare. In contrast, in the U.S. these are among the most costly life time expenses.

Thus, the gradual decline in benefits offered by social programs in the EU promises to transform the European mentality. You see, **one of the reasons why the U.S. has had such a high labor utilization is because the people have been forced to work.** More Americans are working more than one job, two-income households are the norm, and more elderly Americans are either delaying retirement, or else continuing to work part-time by necessity. I have discussed the decline in U.S. living standards on numerous occasions, including the detailed analysis presented in America's Financial Apocalypse.

In addition to a long trend of gradually declining living standards, there have been other factors that have boost labor force participation in the U.S. The consumer credit industry fueled by destructive policies of the Federal Reserve have made consumers addicted to spending money they don't have.



1 Weighted average of countries (population as weight).
SOURCE: World Health Organization; World Economic Forum; Vision of Humanity; CIA; UN Office on Drugs and Crime

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EUROPE'S DEFLATIONARY FUTURE

We are now seeing how the global banking mafia has aligned Europeans with credit. While some changes have been good, most have not. In most EU nations, consumers can buy a home with a mortgage. This was previously impossible in some EU nations. But does this really represent a positive change?

The problem is that Europeans are now falling into the same trap as Americans. I expect this to present a huge problem down the road. For now, Europe has bigger problems to face; namely an economy in chaos buttressed alongside a demographics tsunami that promises to inflict a very long period of diminished median net income, as global oligarchs and bankers carve up their social system.

On the remainder of this page I present some excerpts of a previous publication to remind you of the big picture…

"Washington has handed out trillions of dollars in a variety of forms as a manner by which to fool the America people, from home and auto subsidies, to emergency relief for states.

As a result of this printing frenzy by the Fed and wasteful tax dollars, the economy has registered 3 consecutive quarters of GDP growth according to the agencies responsible for manipulating the data. ***When adjusted for debt spending and adjusted for expenditures that do not contribute to improved living standards, there has been not one quarter of real economic growth since 2007.***

In fact, if we go back to 2002, there have only been maybe 4 or 5 quarters of GDP growth (out of 30) after adjusting for debt spending and other tricks used by Washington and the Fed to create the illusion of a recovery.

From February, you will recall I stated…

'In order to get the unemployment rate down by just 1%, GDP would have to grow by at least 5% by 2010, which is virtually impossible, even with the massive spending by Washington. Based on this, you can make your own estimates about how long the U.S. will have a high unemployment rate.

I'll give you some assistance here. In the BEST of scenarios, based on current spending projections, I would estimate that over the next ten years, GDP will grow by an average of 3.5%.

But the U.S. would need at least 5 years of GDP growth at around 5% in order to bring unemployment down to around the "fully employed" level of around 5.0%. That also assumes the other five years will average about 3-3.5% GDP growth.

I can tell you now this scenario is EXTREMELY unlikely, UNLESS we see many additional stimulus packages. But of course additional stimulus packages will be like trading apples for apples because more debt spending will hamper the long-term growth of the economy.

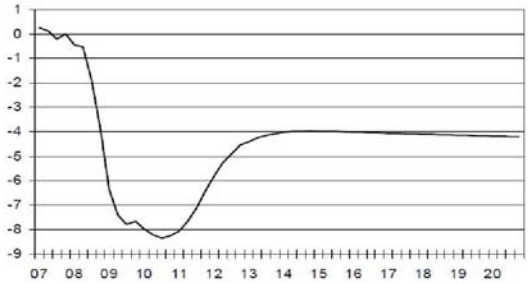
As you can imagine by now, what this means is a lost decade at best. You should also note that about 65% of the 5.7% GDP growth was from industrial production; not to meet consumer demand, but to rebuild inventories.

So the next leg is for consumers to deplete inventories so that production will continue. This isn't going to happen. You should expect to see Q1 2010 GDP data much lower and I expect even worse data for Q2 2010.

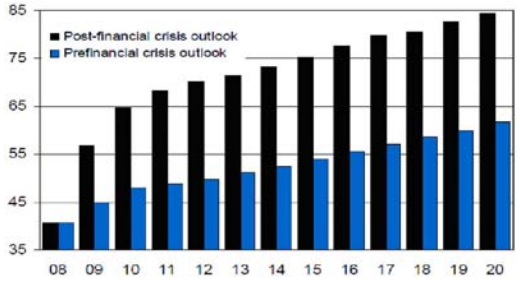
We must also question whether funds are being spent to ensure a long-term recovery by boosting demand. *I have concluded that both objectives have fallen well short of what is required.* ***The effects of this collapse will be felt for at least a decade, probably two.'***

The effects of the collapse have permanently lowered GDP through at least 2020. By some estimates, GDP would have to average 6-7% annually over the next decade in order to recoup pre-crisis levels. That's not going to happen."

Financial Crisis Permanently Lowers GDP



Effect of the Crisis on the Fiscal Outlook of the U.S.



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EUROPE'S DEFLATIONARY FUTURE

As the first chart shows, one can think of macroeconomic disparities in Europe based on geographic regions.

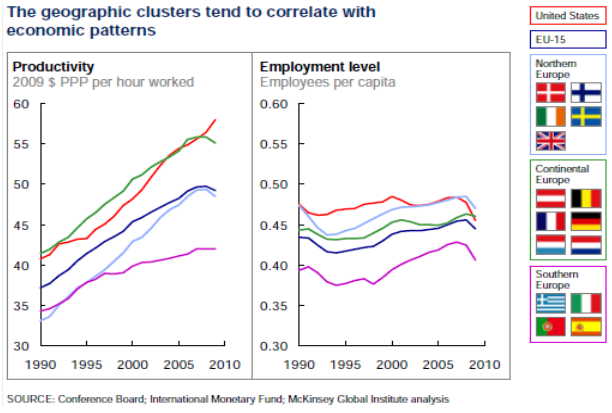
The next chart shows how **Europe's public debt has in many cases already surpassed the legal limits of 60% of GDP established by the EU Maastricht Treaty.** Research has shown that debt levels at 70% of GDP are usually associated with lower growth. Obviously, higher debt levels accentuate this predicament. This should be obvious because a good chunk of expenditures is devoted towards paying interest on this debt. Furthermore, as the debt rises, investors become concerned as to default possibilities, which makes refinancing transactions more difficult. At best, refinancings always come with a higher interest rate.

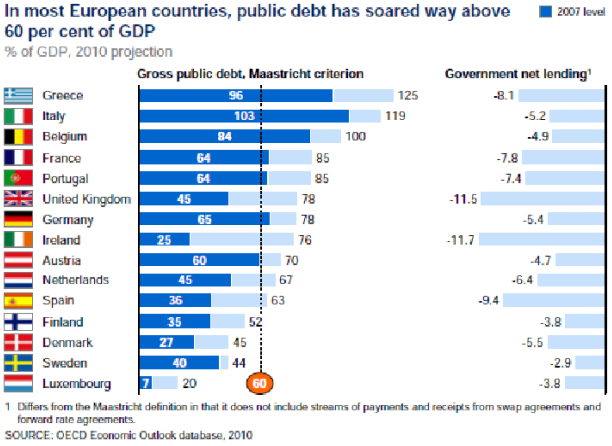
Recall that the majority of this debt ratio has been established as a result of diminished productivity due to the global financial crisis and economic stimulus plans that followed. As a condition for the multibillion-euro bailout package from EU members and the IMF in early summer 2010, Greece must cut its budget deficit by over 10% of GDP. Without the help (yet) of a EU and IMF bailout, Spain intends to reduce its deficit by 8% of GDP, the UK by 7.2%, France by 5.2% and Portugal by 4.3%. This is going to slow economic growth for some time. However, that might turn out to be the best-case scenario.

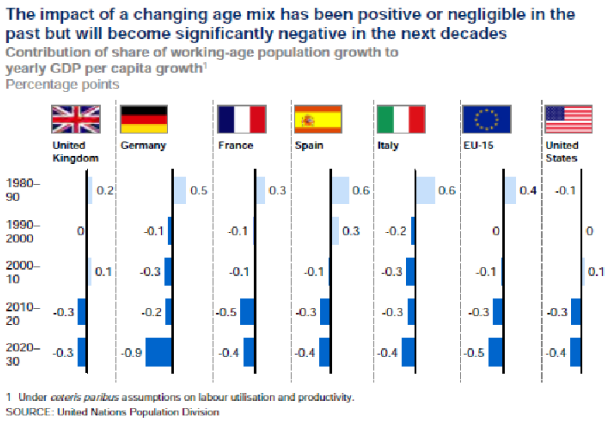
The final chart on this page points once again to the challenges faced by Europe and the U.S. due to the demographic shift. In the past, the proportion of the population that falls into the working segment (the working portion of the population) has contributed a sizable portion to GDP growth. For instance, in the 1980s, the large size of the working population added 0.5% GDP to annual productivity growth. On average, the large percentage of workers versus retirees added 0.5% GDP to Europe in the 1980s. This component has gradually declined due to the demographic shift.

By 2030, the decline in workers will subtract 0.4% GDP from annual growth. As the chart shows, Germany will be hit hardest with a loss of 1.4% GDP annually compared to the 1980s and a 0.7% GDP between 2020 and 2030.

Also included but not shown are similar challenges in Japan and Southeast Asia. You should review the material from the Global Pension Risk in order to gain the full picture.




In most European countries, public debt has soared way above 60 per cent of GDP
2007 level
% of GDP, 2010 projection
Gross public debt, Maastricht criterion
Government net lending¹
Greece 96 125 -8.1
Italy 103 119 -5.2
Belgium 84 100 -4.9
France 64 85 -7.8
Portugal 64 85 -7.4
United Kingdom 45 78 -11.5
Germany 65 78 -5.4
Ireland 25 76 -11.7
Austria 60 70 -4.7
Netherlands 45 67 -6.4
Spain 36 63 -9.4
Finland 35 52 -3.8
Denmark 27 45 -5.5
Sweden 40 44 -2.9
Luxembourg 7 20 -3.8
60
1 Differs from the Maastricht definition in that it does not include streams of payments and receipts from swap agreements and forward rate agreements.
SOURCE: OECD Economic Outlook database, 2010


The impact of a changing age mix has been positive or negligible in the past but will become significantly negative in the next decades
Contribution of share of working-age population growth to yearly GDP per capita growth¹
Percentage points
United Kingdom
Germany
France
Spain
Italy
EU-15
United States
1980–90 0.2 0.5 0.3 0.6 0.6 0.4 -0.1
1990–2000 0 -0.1 -0.1 0.3 -0.2 0 0
2000–10 0.1 -0.3 -0.1 -0.1 -0.3 -0.1 0.1
2010–20 -0.3 -0.2 -0.5 -0.3 -0.3 -0.3 -0.3
2020–30 -0.3 -0.9 -0.4 -0.4 -0.4 -0.5 -0.4
1 Under ceteris paribus assumptions on labour utilisation and productivity.
SOURCE: United Nations Population Division

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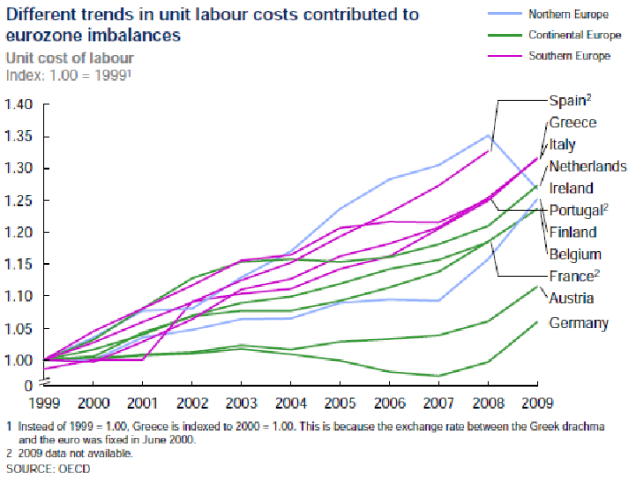
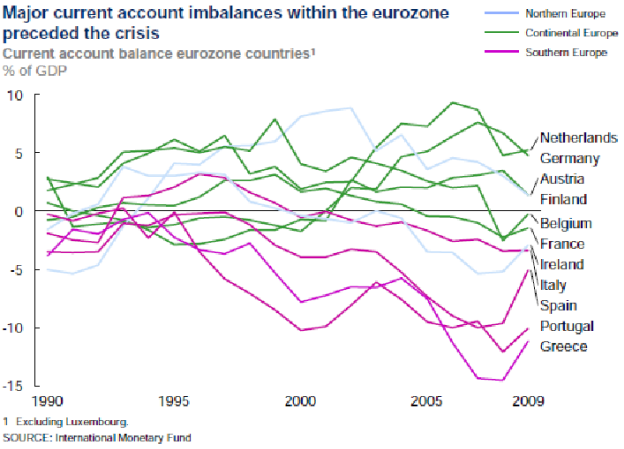
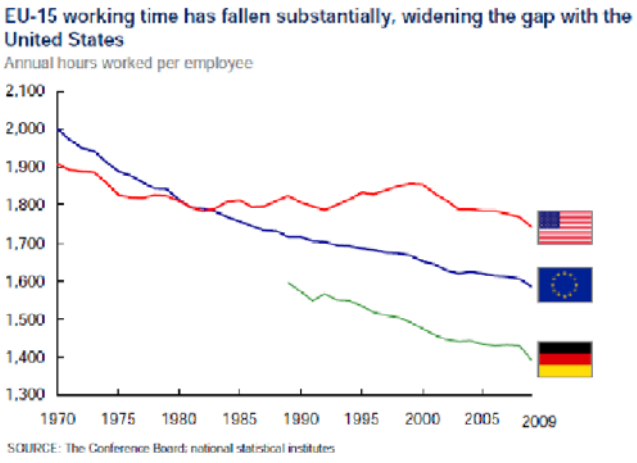
EUROPE'S DEFLATIONARY FUTURE

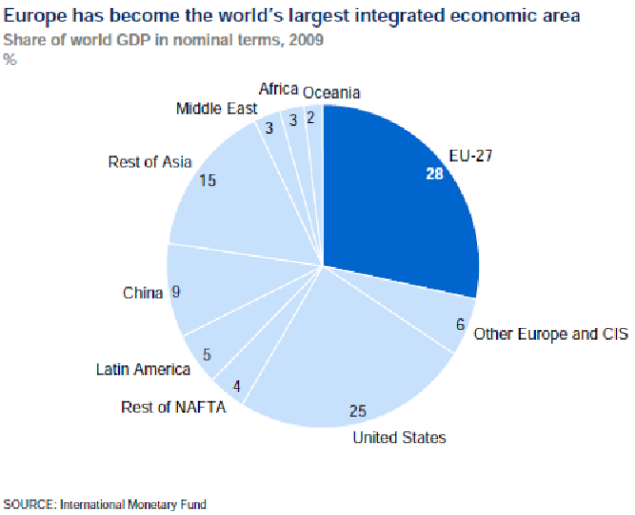
Despite the adverse impact of an aging population, it does offer some small benefits. For instance, expenditures due to unemployment benefits and education decline as the percentage of workers declines. However, this is very minor when stacked against the loss in productivity due to the declining number of workers and the increased healthcare costs due to the increased number of elderly individuals.

After subtracting the small savings from reduced unemployment and educational costs, **the European Commission estimates that expenditures for pensions, healthcare and long-term care will result in an additional "off-balance sheet commitment for EU governments of 3% of GDP as early as 2035 and 4.8% of GDP by 2060.**









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EUROPE'S DEFLATIONARY FUTURE

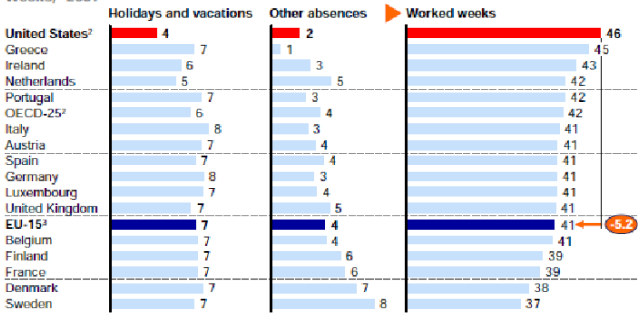
The EU-15 still has a substantial per capita GDP gap with the United States

Per capita GDP, 2009
PPP, $ thousand

SOURCE: The Conference Board; Eurostat; Global Insight; International Monetary Fund; McKinsey Global Institute analysis

EU-15 employees work five weeks less on average than their US counterparts

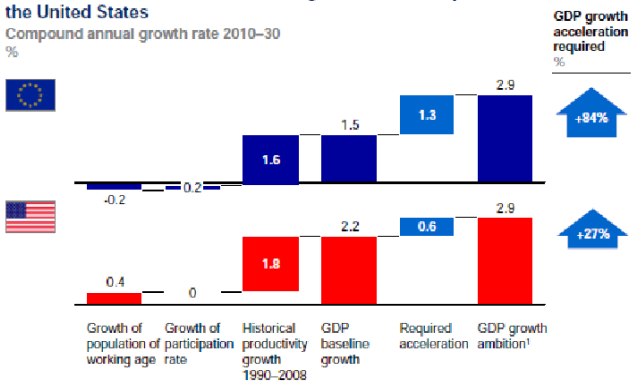
Weeks,[1] 2007



1 Dependent employees, full-time equivalent.
2 2005.
3 Simple average.
Note: Numbers may not sum due to rounding.
SOURCE: OECD

The EU-15 needs to accelerate GDP growth to catch up with the United States

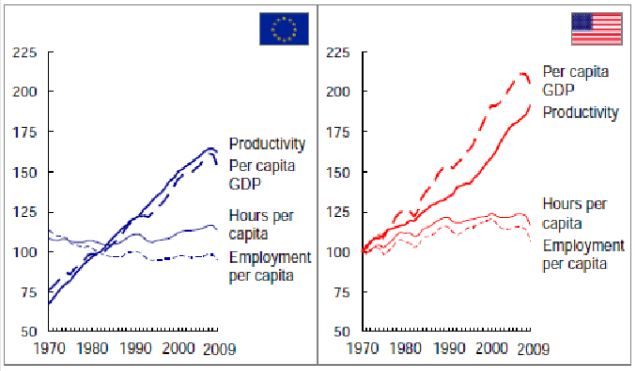
Compound annual growth rate 2010–30
%



1 Set to the US historical GDP growth rate (1990–2008). OECD forecast for 2012–25 growth is 2.4 per cent for the United States, 1.9 per cent for EU-15 in base scenario of *Economic Outlook* No. 87; historical EU-15 GDP growth is 2.0 per cent.
Note: Numbers may not sum due to rounding.
SOURCE: The Conference Board; United Nations Population Division; BLS; EC; McKinsey Global Institute analysis

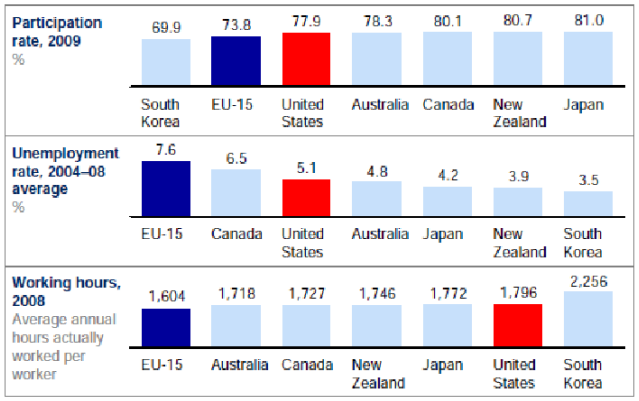
In the long run, productivity is the main driver of economic wealth

Economic growth
Indexed:[1] 100 = United States 1970



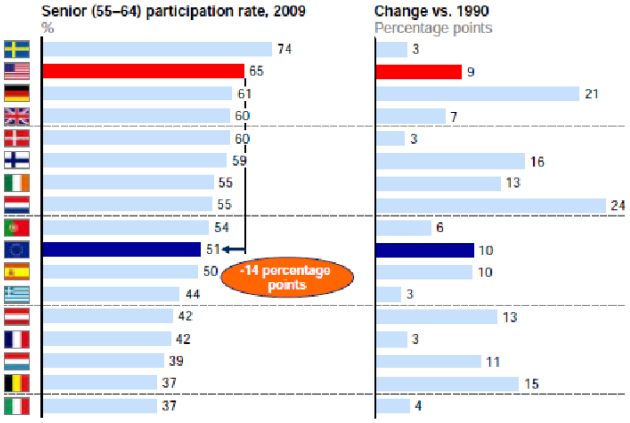
1 The trends are based on real growth.
SOURCE: The Conference Board; McKinsey Global Institute analysis

A significant gap remains in terms of participation rates, structural unemployment, and hours per employee



SOURCE: OECD

Senior participation in the US labour market far exceeds that of the EU-15



SOURCE: OECD

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EUROPE'S DEFLATIONARY FUTURE

Ireland has recently received a bailout of $113 billion, but I feel this will not be sufficient. Either more funds will be required, or else very severe cuts that threaten to cause civil unrest will need to be made. Furthermore, we are very likely to see Portugal followed by Spain lining up for bailout funds. The global shoe could very well drop when Spain lines up for its rescue funds. Thereafter, we are likely to see several other Southeaster European nations follow suit.

In the February 2010 issue I discussed that the global bubble has reflated. I continued this discussion the following month. Since then we have seen what any astute investor would expect; soaring prices for commodities. Once again, the best hedge against inflation has been and will always be oil (which I do not consider to be a pure commodity) followed by commodities. And if anyone ever tells you anything different they simply have no credibility. Due to the dollar-oil link as well as its vital importance, oil is the best commodity to use when hedging against inflation. This is specifically why I have been pushing oil in this newsletter.

Since World War II, nearly every major financial crisis has been followed by a long period of deleveraging. Deleveraging can occur by several means, such as default, intentionally raising inflation as a manner by which to pay off debt, austerity measures and fiscal responsibility.

Thus far, the global banking syndicate has prevented a complete default of several nations (Iceland, Greece, Ireland) but mounting problems for these and others nations is on the horizon.

However, when market forces are disrupted by government bailouts, this creates inflation. At the same time, while officials debate the details of austerity and fiscal responsibility, the problem is that the Federal Reserve refuses to properly deleverage. In fact, it is pumping the global bubble up to higher levels.

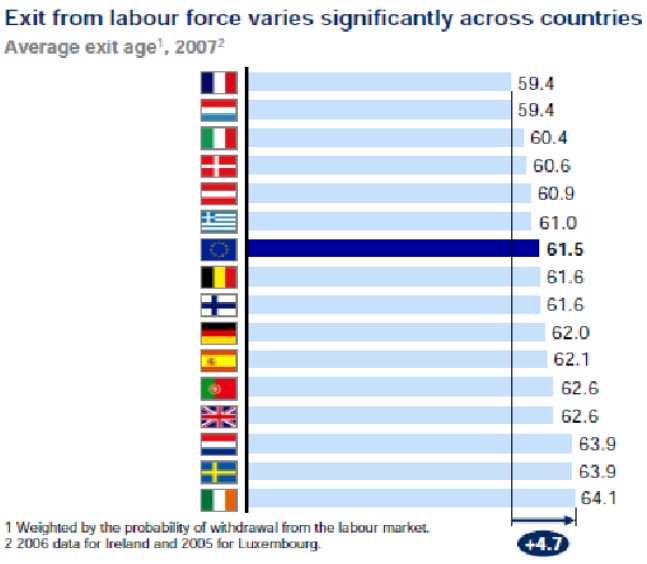
Similar to many economies around the world, Europe's population is aging as a result of increasing life spans, lower fertility rates, and an aging baby boomer population. **But Europe faces a significantly larger problem from this demographic tsunami for two critical reasons.**

First, European government expenditures are tied into population demographics to a greater extent in comparison to the U.S. This relationship is due to Europe's generous social system, which has a bigger hand in pensions and healthcare.

Second, population growth in Europe over next several decades is expected to be much lower than in the U.S. For instance, the EU-15 population is projected to grow by only 3% from 2010 to 2050, while in the U.S. the population is projected to grow by 27%. Part of this difference comes from the much lower immigration rate seen in Europe relative to the U.S.

Finally, life expectancies are higher in the EU-15 than in the U.S. This means more of the population will be aged, and less likely to remain in the labor force.

The chart below shows labor force exit rates (retirement, disability, and other reasons for leaving the labor force) in Europe by nation.



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EUROPE'S DEFLATIONARY FUTURE

If we consider demographic estimates from the EU-27, by 2050 there will be one retiree for every 1.5 workers. This is in contrast to the current 1 for 2.6 ratio.

From simple math, this means that **by 2050, the average worker in the EU-27 will be faced with a 60% higher burden to support the beneficiary pay-out period of retired workers.**

These demographic trends can only be altered by forces of nature. But governments can AND WILL alter retirement and healthcare benefits.

Thus, the demographic trends faced by the EU are likely to be met with some combination of significantly higher taxes, fewer benefits, and a significant increase in labor participation rates, especially in the elderly population.

You should expect to see minimum retirement age raised in most EU nations several times over the next few decades. This is process has already commenced. While the U.S. also faces a similar situation, it is not as severe.

The effect of this demographic shift, along with the effects of the global economic crisis will be present for several decades. These trends will adversely affect consumption, per capita GDP and living standards.

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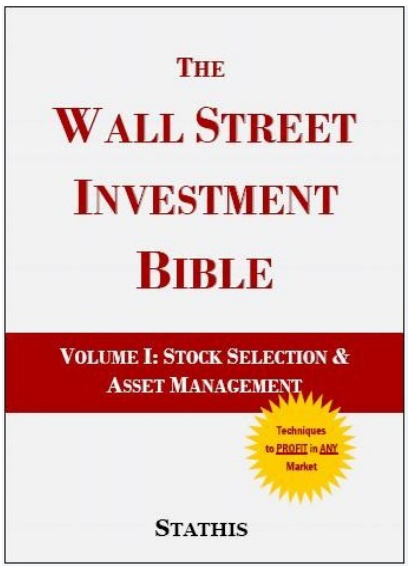
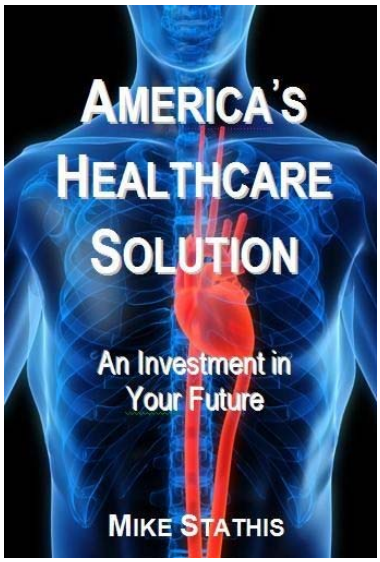
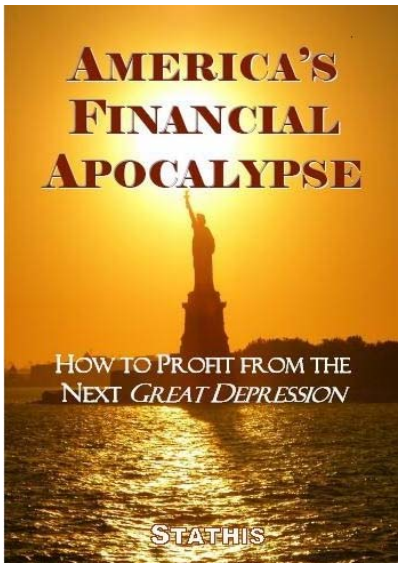
A MUST FOR ALL SERIOUS INVESTORS







Investment Intelligence

When it REALLY Matters

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